Shermag inc.

ANNUAL REPORT

1998
1999

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1998
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OUR *mission*

Shermag's corporate mission is to produce the highest quality furniture available in the marketplace. While fully aware of the importance of assuring the Company's shareholders a positive return on their investment, Shermag's management is also concerned about offering fair working conditions to its 1,700 employees.

COMPANY *profile*

Shermag is a leader in the production and distribution of high-quality residential furniture. The Company enjoys an enviable reputation in the North American market and figures prominently in the design of contemporary-style furniture.

Shermag's facilities include a network of medium-size factories equipped with state-of-the-art technology. Vertical integration – from the forest to the retailer – gives the Company an exceptional competitive edge in a highly fragmented industrial sector. Three hardwood sawmills, a plant specializing in the fabrication of components, and a veneer plant all contribute to the efficiency of the Company's ten furniture manufacturing facilities and to a lowering of production costs.

Shermag focuses on specific markets in the sale of its products. Major department stores in the United States and Canada, multiple-location chain stores specializing in the distribution of high-end furniture, as well as the best independent retailers comprise the Company's marketing targets.

A L
g h t s

April 3 1998	April 4 1997	March 29 1996	March 31 1995
109,438	88,584	65,518	55,688
103,887	84,244	62,283	53,519
81,887	62,973	43,333	33,227
75%	71%	66%	60%
34,025	28,590	22,542	18,756
13,098	9,597	6,160	4,279
9,507	6,468	5,193	2,802
13,282,674	11,232,674	10,382,674	9,988,556
0.78	0.60	0.51	0.28
0.78	0.57	0.47	0.25
4.31	1.99	1.42	0.89
18.25	12.70	4.75	1.90
23.4 x	22.2 x	10.1 x	7.6 x
109,171	76,418	61,520	50,807
32,969	15,094	7,337	7,453
12,760	18,114	14,087	15,323
57,662	22,799	15,156	9,383
12,252	9,795	7,976	4,657
31.09%	32.27%	34.41%	33.68%
8.69%	7.30%	7.93%	5.03%
1.96 : 1	1.47 : 1	1.25 : 1	1.32 : 1
0.22 : 1	0.79 : 1	0.93 : 1	1.63 : 1
24%	34%	42%	35%

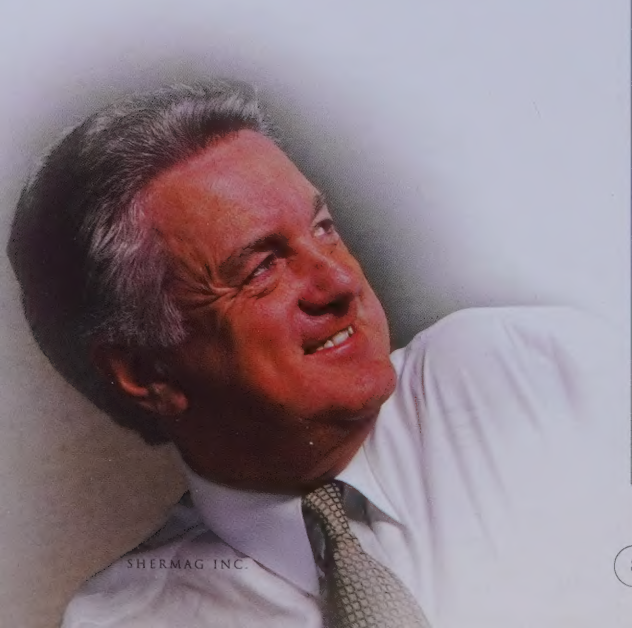
1998-1999 FISCAL YEAR

During fiscal 1998-1999, the gross revenue of the Shermag Group increased 17% to $128,134,000. Pre-tax earnings remained stable at just over $13,000,000. In fact, these results represent a 15% rise in operating profits since a non-taxable non-recurring revenue item of $1,900,000 had increased earnings per share by $0.16 the previous year.

There is no question that certain circumstances affected performance in the last four quarters and during the year we reported on the factors that influenced the quarterly results. In regard to both the quality of raw material supplies and problems related to reengineering the internal information system, appropriate steps have been taken to correct the situation. Another factor also played a part in preventing us from achieving our objectives, namely, the organization of production in one division in particular. This aspect warrants a more detailed explanation.

THE PRICE OF GROWTH

Over the years, circumstances caused Shermag to concentrate primarily on producing bedroom furniture which, excluding the glider rocker sector, used to account for 90% of the Group's sales. However, no major furniture manufacturer in North America can or should specialize in just one room of the house because the sales strategies used by the large retailers favor the provision of complete collections in the stores (total environment). Therefore, manufacturers must offer collections that include bedrooms, dining rooms, living/family rooms and home offices.



Our research revealed that we were neglecting a sector of the market that should have generated 35% of the normal sales of a company like ours, and this represented our best development potential. To take advantage of this opportunity, Shermag had the choice of buying a manufacturer with a production capacity of approximately $50 million per year or building a brand new network with the same capacity.

We felt the acquisition of this type of company would impose too large a burden on the Company, and therefore decided to develop by acquiring the plants in Sainte-Gertrude and Granby, retooling the Saint-Étienne plant and converting the Scotstown plant to manufacture dining room furniture. Thus, without taking on substantial new debt, the Company acquired the means to meet the needs of its customers who prefer complete collections.

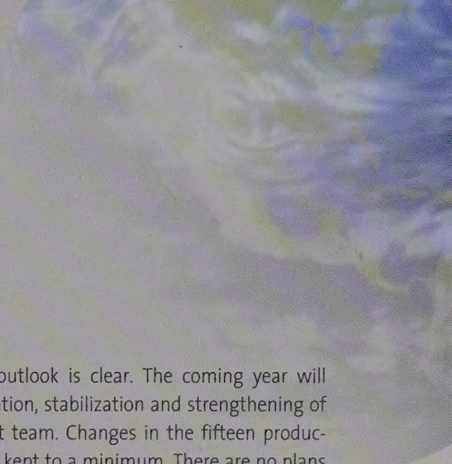
The introduction of new technologies in these plants, the training of new employees, and the break-in period required to achieve satisfactory quality standards had an impact on the productivity of the Bédard Division and its results drove down the gross margin of the whole Group. Thus, while some of Shermag's divisions generated gross margins of 40%, Bédard only achieved 15.2% during the fiscal year.

The "pay as you go" development approach adopted by Shermag enabled us to make headway without expensive acquisitions and the shareholders were rewarded with an excellent financial position on the balance sheet and a high return on shareholders' equity.

PRODUCTION

Investments in production equipment reached a record high this year. Capital expenditures were made to modernize the plants in order to improve labor productivity in the existing manufacturing units and to add four new production units to the network.

These investments, totalling nearly $20 million, boosted total production capacity to over $220 million. This capacity will probably be fully utilized during the next two years. Investments included the construction at Edmundston, New Brunswick, of the most modern home furniture production facility in Canada; the relocation of Sofas International S.I. Inc.'s operations to a spacious building four times larger than the previous plant; the acquisition at a bargain price of a hardwood sawmill and a wood processing plant in Maine (Woodtek); and the complete retooling of the Sainte-Gertrude plant to convert its main operations. New technologies and new production



processes (stand-alone cells) were also put in place in the Lennoxville and Saint-Étienne plants.

The Company also invested heavily in human resources training and four plants are preparing to receive ISO 9002 certification.

Therefore, in terms of both equipment and human resources, there were significant changes and adjustments in the plants resulting in the inevitable impact on productivity.

MARKETING

There were no strategic changes in terms of marketing during the fiscal year. We continued to concentrate efforts in Canada and the United States, focus on the large U.S. retailers (Plans A, B, C) and improve our sales organization in Canada. The Company's U.S. sales increased 22.4% and now account for 78% of gross revenue. This trend will continue in the coming year thanks to greater penetration of the dining room furniture sector.

As for the Canadian market, after three years of stagnation, it is important to note that sales increased 9% over the last two fiscal years. The Canadian team has agreed that it will not be outdone by the U.S. team in the future and will continue to improve its performance.

ADMINISTRATION

Shermag is finishing a decade with a compound annual growth rate of over 25% which gave its shareholders one of the best rates of return in the industry in North America. This achievement was not accidental, nor was it the result of special outside circumstances. It was the result of sound management and the sustained efforts of a dynamic team of men and women who had a clear vision of their mission. However, Shermag's rapid, constant growth necessitated changes in the Company's administrative structure. Several senior management positions were created including those of Executive Vice-president and Chief Operating Officer, Vice-president Finance and Vice-president Production. The President of each division also received better logistical support with the addition of a Planning Coordinator.

Finally, new software (J.D. Edwards) and a new computer, which came on line on December 4, 1998, successfully ushered the Company into the Y2K environment and provided senior executives with real-time management tools worthy of their aspirations.

OUTLOOK

The short-term outlook is clear. The coming year will feature consolidation, stabilization and strengthening of the management team. Changes in the fifteen production units will be kept to a minimum. There are no plans for major investments in buildings or equipment. There will be no significant changes in production processes or management personnel. There will also be very few additions to our product lines because of the success of the current collections. It is unlikely that there will be any major acquisitions.

In the medium term, sales growth should generate a situation where Shermag's increased production capacity can be fully utilized and another expansion cycle through acquisitions can be initiated.

THANKS TO OUR TEAM

Once again, I would like to express my gratitude to everyone who has contributed to Shermag's success. Our Company offers opportunities for its shareholders and ample reasons for our staff to be proud. Success in business is never the result of unfocused efforts. Success can best be achieved through the sustained efforts of dynamic, intelligent men and women who have a clear mission and who do what it takes to achieve their objectives. Shermag is made up of such men and women. Every single one of our 1,700 employees contributes, in his or her respective way, to the Group's success. They are the workers in the plants who efficiently manufacture excellent quality products; they are the office staff who provide the logistical support required for efficiently delivering goods and services; they are the sales representatives who carry the Shermag standard to the four corners of the North American continent; they are the executives who organize and put in place the different elements required for the successful development of production and sales; and, finally they are the members of the Board of Directors who shape the Company's future and make the major decisions.

To all these fine people, all part of our remarkable team, I say thank you!

Serge Racine

Chairman of the Board,
President and Chief Executive Officer

REVIEW OF *operations*

The very competitive environment brought about by free trade means that all companies that aspire to becoming major players on the North American stage have to take into consideration a large number of factors in their development strategy.

At Shermag, product quality, competitive pricing, innovative styling, customer service and other key success factors are the result of a simple but effective strategy implemented nearly ten years ago. This strategy is based on two important elements in the way we do business: vertical integration of the production chain and protection of our markets.

PRODUCTION

Our production chain is continuous: from felling the tree, right to our customers' stores. Unlike most of our competitors who simply assemble furniture, Shermag buys the hardwood logs, converts them at its sawmills, dries the boards in its kilns, makes its wood components (machined, bent and turned parts), and assembles, finishes and delivers the goods to the customer's warehouse.

People who favor extreme specialization sometimes question this degree of integration. However, there is no doubt that in our case, this strategy produces better results in terms of controlling both raw material quality and production costs. Our very efficient sawmills (Mégabois, Montauban, Woodtek) mean that we can eliminate various intermediaries and have better control over major fluctuations in wood prices. Manufacturing our own veneer (Placages Lennox) to plant specifications reduces losses in the use of particle board and lowers costs. Controlling the transportation of finished products to our customer's door generates better efficiency in picking up the products manufactured in ten different production facilities and guarantees our customers faster, better organized and cheaper delivery.

Vertical integration was taken one step further this year. The sawmills provided nearly 70% of the hardwood supplies which account for 40% of production

costs. The production capacity of the veneer plant was doubled so the Company is now self-sufficient in veneers.

We have convinced our customers to let us coordinate their furniture deliveries which means that we can now manage an organized distribution network based on an established schedule for North America. Very few of our competitors have this type of system and this service has become a formidable competitive element.

In the coming years, Shermag will continue to increase the added value of its products through even better integration of its production chain and will thus share the benefits of this strategy with its partners/ customers.

MARKETING

Fifty customers account for 83% of Shermag's sales and no single customer represents more than 10% of our total revenue. Of particular note is that these fifty major customers increased their orders for Shermag products by 31% during the first six months of calendar 1999.

These results which would be any company's dream, were achieved after many years of efforts to build a customer base from the finest retailers in North America and make them real business partners. Our success in this regard is the result of delivering a high quality product at the best possible price and introducing innovative styles and textures. But the main reason for this success is that we protect our customers' markets by providing exclusive products, segmenting the distribution of our furniture collections to avoid "inundating" an area with the same product and helping our retail customers enhance their profit margin. It is not always possible to guarantee this type of protection but it is a well-known fact that Shermag does it better than anyone else in the industry.

Market segmentation depends on a good niche marketing strategy, which is why we are trying to develop an increasingly detailed analysis of our specific markets, namely upscale and medium-range wood furniture retailers, with a particular focus on the large chains and finest independent stores.

With the experience it has acquired and an increasingly solid reputation, Shermag is now in a position to push this marketing strategy even further. However, we must continue to keep a close watch on the constant developments in our target sectors and adapt quickly to these changes.

SCOTSTOWN DIVISION

The Scotstown Division increased its sales 17% during the year and now accounts for 24% of the Shermag Group's total sales.

The Scotstown plant was recently transferred from the Nadeau Division to join the Disraeli and Bishopton plants that formed the core of the Scotstown Division's production capacity. The Scotstown Division is operating at 70% of its increased production capacity of nearly $60 million. Given the popularity of the Division's major collections such as *Florence*, *European Country*, *Tuscany* and *Orientation*, we hope that this capacity will be fully utilized within the next 24 months.

One of the Scotstown Division's outstanding achievements this year was to cut the number of products it manufactures by half, yet maintain a growth rate equivalent to the Group average. Reducing the number of products and increasing concentration on the most successful products are always desirable

objectives to improve plant efficiency and productivity, and consequently quality and customer service.

During the current year, we expect this Division to double the growth rate achieved last year and to make an outstanding contribution to Shermag's results.

NADEAU DIVISION

The Nadeau Division, which originally comprised the plants in Saint-François-de-Madawaska, Victoriaville (HPL) and Scotstown, increased its sales by 13%. It accounts for 40% of the Company's total sales.

Nadeau is the perfect example of what must be the ideal situation for a furniture manufacturer... three plants, four furniture collections, excellent product quality, remarkable stability in processes and technology, and an experienced, competent workforce. We have talked before about this Division being Shermag's flagship and this description still holds true.

During the year, the Nadeau Division built a new plant at Edmundston, New Brunswick. It is the only brand new furniture manufacturing facility built in Canada in the last ten years. It is also the most advanced in terms of technology.

This new facility which has a production capacity of approximately $30 million replaced the Scotstown plant in the Scotstown Division in May last year.

CHANDÉRIC/CONANT BALL DIVISION

The Chandéric Division manufactures glider rockers at its Lennoxville plant. This division increased its sales by 14% last year and has a substantial number of large, loyal customers.

Over the last two years, major investments in equipment and production processes at the plant helped Chandéric enhance its production efficiency and maintain its competitive position despite Asian imports that were attractive because of the depreciation of Asian currencies.

The Lennoxville plant also came to the rescue of the Bédard Division during the last fiscal year by producing a great number of dining room chairs, thus adding some versatility to this plant which had manufactured only one product line for the past twenty years.

were making for the other divisions (tables and chairs for the major collections) back to their original production units. As for the newly installed machine tools, particularly in regard to converting operations at Sainte-Gertrude, the technological knowledge required to optimize performance is being acquired rapidly. The effect of these measures is already being felt and we expect Bédard to achieve normal growth in the coming year.

SOFAS INTERNATIONAL

In its third year, Sofas International grew 133%. Buoyed by a very simple product line, the Sofas International Division has adopted a sales target of $10 million for fiscal 2000.

Growth on this scale forced the Saint-Léonard based Division in the last quarter to move into a facility four times larger. To meet the needs of Sofas International, Shermag purchased a 60,000 square foot plant in Saint-Léonard last February. This Division thus acquired pleasant, modern premises and presently occupies only half the available space. When it occupies all the space, its production could reach $40 million.

Like Shermag's other divisions, Sofas International is in the process of building a position in the United States, a market which currently accounts for only 45% of its sales.

MÉGABOIS

Mégabois which comprises the Lac-Mégantic and Notre-Dame-de-Montauban sawmills also performed satisfactorily during fiscal 1999. These two mills supplied the network of furniture production facilities with 70% of their hardwood requirements.

REVIEW

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BÉDARD DIVISION

The Bédard Division, as it stands today, is a new initiative that was developed over the past two years. The Division started with a small plant producing \$3 million worth of furniture two years ago at Saint-Étienne-de-Lauzon, then added the Sainte-Gertrude and Granby facilities in 1997. Today it is a major division with a production capacity of over \$30 million.

The development of Bédard as an important producer of dining room furniture is one element in Shermag's overall strategy. A furniture company the size of and as ambitious as Shermag must have specialized units manufacturing dining room furniture, since this market segment should account for 35% of its total sales. Before the Bédard Division was created, dining room sales accounted for only 10% of the Group's sales but now represent nearly 25% of its revenue and the strongest growth sector.

However, the integration of these three specialized plants proved to be more difficult than expected. In fact, the dining room division was the victim of its own, too rapid, success. The sales strategy for the *Portfolio* collection, in particular, coupled with the decision to transfer to Bédard the manufacturing of the chairs and tables for all the other divisions, completely congested this network of three plants which did not have the time to follow a normal development and learning curve. In addition to these changes, the rapid introduction of new technologies, especially at Sainte-Gertrude, required a longer break-in period than anticipated.

The situation is now under control. We have strengthened the management team of this Division, both in the plants and at the senior management level. We have simplified the product line by reducing the selection of tables and chairs by 50%. And most importantly, we have transferred the products that its plants were making for the other divisions (tables and chairs for the major collections) back to their original production units. As for the newly installed machine tools, particularly in regard to converting operations at Sainte-Gertrude, the technological knowledge required to optimize performance is being acquired rapidly. The effect of these measures is already being felt and we expect Bédard to achieve normal growth in the coming year.

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Mégabois which comprises the Lac-Mégantic and Notre-Dame-de-Montauban sawmills also performed satisfactorily during fiscal 1999. These two mills supplied the network of furniture production facilities with 70% of their hardwood requirements.

Apart from the problem of the bacteria that attacked the log inventory at the Lac-Mégantic plant in the second quarter, the Division had a good year and operated at full capacity throughout the year. A new supply agreement with an important group of US wood dealers provided the mill with a solid, efficient supply channel for maple and birch.

For Montauban, however, wood material supplies from Crown lands proved difficult. The land where cutting is currently taking place contains only a small amount of hardwood and it was necessary to make up for the reduced supplies for this sawmill with inventory from the United States. This situation affected the profitability of the Montauban facility which was unable to generate an operating profit in its first year of operations.

WOODTEK

The acquisition of Woodtek in Maine was the business "coup" of the year. This company which was acquired in February, comprises two production facilities. By far the most important is a hardwood sawmill which has a capacity equivalent to that of Mégabois and this was the main reason for the acquisition. It also has a plant that manufactures wood by-products.

Woodtek was put up for sale by the creditors of its parent company, United Timber, LLC, and because of these special circumstances, it was a very profitable transaction for Shermag and provides a more secure supply of hardwood for its furniture manufacturing network for the future.

PLACAGES LENNOX

The mission of Placages Lennox is to supply the veneer for all Shermag's production facilities. It achieved most of this mission last year since, with a 61% increase in its production; the plant which is also located in Lennoxville was able to meet nearly 80% of the Group's requirements.

The veneer manufacturing plant has now reached full capacity. Since the development of furniture collections will include an increasing percentage of veneers – to save on the use of hardwood – the Company is currently looking at ways to increase production capacity at Placages Lennox. It is not inconceivable that the plant could also sell to outside customers since this product is in such great demand.

OPERATING *results*

Shermag's gross revenue for the fiscal year ended April 2, 1999 totalled $128,134,000, up 17.1% from $109,438,000 in 1998. Over the past five years, the Company has recorded a compound annual growth rate of 24.1%. Sales to the United States represented 78.2% of total revenue and grew 22.4% whereas Canadian sales which account for 21.8% of total revenue showed minimum growth.

PROFITABILITY

Net earnings for the 1998-1999 year amounted to $8,704,000 or $0.66 per share (diluted and undiluted) compared to $9,507,000 or $0.78 per share (diluted and undiluted) the previous year.

However, this comparison does not take into consideration two important factors. The first was a non-recurring gain of $1,900,000 arising out of the redemption of preferred shares, which increased earnings per share last year by $0.16. The second element was the effect of the full dilution in 1998-1999 ($0.08 per share) versus a weighted effect in 1997-1998 ($0.05 per share) of the public offering of 1,600,000 common shares in October 1997.

As a percentage of gross revenue, the gross profit margin (before amortization) was the same as last year, namely 30%, not taking into account the non-recurring gain mentioned above.

The cost of goods sold remained at 64% of sales. As a percentage of total costs, raw material costs dropped, while labor costs and overhead increased. These variations indicate that the Company benefited from greater self-sufficiency in the supply of rough timber because of its three sawmills, as compared to last year when it had to buy more from other suppliers. On the other hand, labor costs increased because of training expenses required by the numerous technological changes in the plants over the past two years. Finally, the start-up and break-in of some plants were particularly difficult during the last year, especially at the Sainte-Gertrude and Granby plants.

Selling and administrative expenses rose 10.8% from $16,599,000 to $18,398,000, whereas sales grew 17.1%. These expenses represent 14.4% of sales as compared to 15.2% last year. Selling expenses were similar to last year even with additional revenue of $18,696,000.

Administrative expenses, on the other hand, rose 30% following the full effect of an increase in corporate administrative personnel during the year and certain non-recurring compensation items. The Company had to expand its team to better manage its growth.

Financial expenses rose from $1,184,000 (1.08% of gross revenue) in 1998 to $2,640,000 (2.06%) in 1999. Of this increase $1,296,000 was attributable to a loss on U.S. dollar forward exchange contracts. Interest charges on short- and long-term debt only increased $160,000 for a debt increase of $11,266,000.

Amortization went from $3,144,000 to $4,240,000. The additional $1,096,000 expense was the result of major capital investments during the last two fiscal years totalling $15,329,000 in 1999 and $11,752,000 the previous year. The full impact of these investments is not yet reflected in the plants' production capacity.

CHANGES IN *financial position*

OPERATIONS

Over the last few years, because of its profitability, the Company has been able to generate substantial funds. For the year ended April 2, 1999, cash flow from operations reached $14,186,000 ($12,252,000 in 1998). Of this, $9,894,000 was used to support working capital items and the rest was reinvested in the Company in the form of fixed assets.

INVESTMENTS

The investment program required $20,810,000 in liquid assets, most of which was used to acquire fixed assets ($15,329,000) and some of the assets of a hardwood sawmill in the U.S. ($4,254,000).

These investments completed the technological improvement plan undertaken the previous year which, in addition to improving the Company's self-sufficiency in the supply of its main raw material, increased the Company's overall production capacity in order to meet sustained sales growth.

FINANCING

The Company's ability to generate funds coupled with the profit targets for the year and the fact that this was the end of a long series of investments, permitted fixed asset and business asset acquisitions to be financed out of working capital. However, this temporarily drove down the current ratio from 1.96:1.00 to 1.67:1.00.

In addition, during the year, Company management decided it would be beneficial to review its financial structure by syndicating its short-term loans and most of its long-term loans. The purpose of this restructuring was to obtain a more flexible financing structure capable of supporting short- and medium-term cash requirements in a context of strong sales growth. As a result of this loan syndication, the Company increased its authorized line of credit by $10,000,000, from $22,500,000 to $32,500,000. In addition, a new $12,500,000 term loan was issued by the syndicate, of which $11,300,000 was used to pay the balance of the existing loans owed to the term lenders in the syndicate. By issuing a $70,000,000 debenture to guarantee the syndicated loans, the Company can, if it needs, increase in its authorized credits more easily.

As of April 2, 1999, the Company still had an authorized but unused line of credit and was meeting all the financial ratio requirements of its creditors.

FINANCIAL POSITION

Although the 1999 year was less spectacular than previous years in terms of growth, the results were interesting and the Company consolidated its financial position.

The Company's total assets, 40% of which are fixed assets, increased by $25,000,000 to $134,524,000.

Shareholders' equity stood at $66,378,000 as of April 2, 1999 and the common shares had a book value of $4.96.

RISKS AND UNCERTAINTIES

Shermag has a very high level of exports to the United States and exchange rate fluctuations can have an impact on its net earnings. The Company reduces this risk by employing derivative financial instruments such as forward exchange contracts. The Company also adopts a risk sharing position by taking part of its short-term credits in the form of banker's acceptances, the purpose of which, needless to say, is to protect the Company, not speculation.

OUTLOOK

Shermag is now more self-sufficient in rough timber supplies and is therefore less vulnerable to price fluctuations of this raw material on the market. The Company is also emerging from a period of major changes in its manufacturing processes and some operating problems will not reoccur in the next fiscal year.

Because of the above factors, the steps taken to protect against exchange rate fluctuations and the constant sales growth, we are confident that the Company will continue to perform well and improve its financial position.

Josée Girard

Josée Girard, CA
Comptroller

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YEAR 2000

Shermag has been aware of the problems related to the change in millenium for some time. The extent of possible problems has been identified and evaluated. The Company's dependence in regard to all its computer systems and the possible impacts have been carefully analyzed. Management has put in place a strategic plan with a detailed schedule and presents regular progress reports to the Board of Directors.

This plan includes the following corrective or preventive measures:

- Modification of the computer infrastructure
- Implementation of a new information management system
- Modification of applications not included in the new system and that did not meet Y2K requirements. The Company is using outside consultants to implement most of these corrections.
- Testing of the new system and the modified systems
- Evaluation of risks related to third parties through a compliance confirmation process

Given the progress and results obtained to date, the Company is confident that it will move into the new millenium without any significant disruptions of its operations.

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MANAGEMENT'S *report*

Shermag Inc.'s consolidated financial statements for the years ended April 2, 1999 and April 3, 1998 and the financial information included in this annual report are the responsibility of management. The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in Canada and with the policies set forth in the notes to said statements.

The Audit Committee of the Board is responsible for reviewing the consolidated financial statements in detail, for ensuring that the Company's internal control systems, management policies and accounting practices are adhered to, and for recommending approval of the consolidated financial statements to the Board of Directors.

The chartered accountants, Raymond Chabot Grant Thornton, have audited the consolidated financial statements which appear hereinafter and their report indicates the extent of their audit and their opinion on said consolidated financial statements.

Serge Racine

Racine

Chairman of the Board, President
and Chief Executive Officer

Josée Girard, CA

Josée Girard

Comptroller

AUDITORS' *report*

To the Shareholders of Shermag Inc.

We have audited the consolidated balance sheets of Shermag Inc. as at April 2, 1999 and April 3, 1998 and the consolidated statements of earnings, retained earnings and changes in cash resources for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at April 2, 1999 and April 3, 1998 and the results of its operations and the changes in its financial position for the years then ended in accordance with generally accepted accounting principles.

Raymond Chabot Grant Thornton

General Partnership
Chartered Accountants

Sherbrooke
May 21, 1999

CONSOLIDATED FINANCIAL *statements*

1998
1999

Consolidated Earnings

Years ended April 2, 1999 and April 3, 1998

(Amounts in thousands of dollars, except earnings per common share)

	1999-04-02	1998-04-03
	$	$
Gross revenue	**128,134**	109,438
Less: returns, allowances and discounts	**7,540**	5,551
Net revenue	**120,594**	103,887
Cost of sales	**82,211**	69,862
Gross profit excluding depreciation and amortization	**38,383**	34,025
Selling and administrative expenses	**18,398**	16,599
Financial expenses	**2,640**	1,184
Depreciation and amortization	**4,240**	3,144
	25,278	20,927
Earnings before income taxes	**13,105**	13,098
Income taxes (Note 4)	**4,401**	3,591
Net earnings	**8,704**	9,507
Net earnings per common share	**0.66**	0.78
Diluted net earnings per common share	**0.66**	0.78

Consolidated Retained Earnings

Years ended April 2, 1999 and April 3, 1998

(Amounts in thousands of dollars)

	1999-04-02	1998-04-03
	$	$
Balance, beginning of year	**19,828**	11,170
Net earnings	**8,704**	9,507
	28,532	20,677
Share issue expenses, net of related income taxes of $405		849
Balance, end of year	**28,532**	19,828

The accompanying notes are an integral part of the consolidated financial statements.

Consolidated Changes in Cash Resources

Years ended April 2, 1999 and April 3, 1998

(Amounts in thousands of dollars)

	1999-04-02	1998-04-03
	$	$
OPERATIONS		
Net earnings	**8,704**	9,507
Non-cash items		
Loss (gain) on disposal of assets	**(10)**	333
Amortization of deferred credits	**(114)**	(107)
Other depreciation and amortization	**4,240**	3,144
Deferred income taxes	**1,366**	1,275
Discount on redemption of redeemable preferred shares		(1,900)
Changes in working capital items	**(9,894)**	(14,235)
Source (use) of cash	**4,292**	(1,983)
FINANCING		
Long-term loans	**13,284**	4,868
Instalments on long-term debt	**(13,549)**	(9,755)
Issues of shares	**12**	26,205
Share issue expenses		(1,254)
Redemption of redeemable preferred shares		(1,100)
Source (use) of cash	**(253)**	18,964
INVESTMENT		
Business acquisitions (Note 5)	**(4,254)**	(1,508)
Fixed assets	**(15,329)**	(11,752)
Disposal of fixed assets	**39**	418
Deferred charges	**(1,767)**	(1,538)
Deferred credits	**501**	80
Use of cash	**(20,810)**	(14,300)
Increase (decrease) in cash	**(16,771)**	2,681
Cash position, beginning of year	**(9,996)**	(12,677)
Cash position, end of year	**(26,767)**	(9,996)
CASH POSITION		
Cash (outstanding cheques)	**(1,697)**	1,543
Bank loans and acceptances	**(25,070)**	(11,539)
	(26,767)	(9,996)

The accompanying notes are an integral part of the consolidated financial statements.

Consolidated Balance Sheets

April 2, 1999 and April 3, 1998

(Amounts in thousands of dollars)

	1999-04-02	1998-04-03
	$	$
ASSETS		
Current assets		
Cash		1,543
Accounts receivable (Note 6)	**31,752**	24,875
Inventories (Note 7)	**45,320**	40,246
Prepaid expenses	**582**	482
	77,654	67,146
Fixed assets (Note 8)	**53,858**	39,595
Other assets (Note 9)	**3,012**	2,430
	134,524	109,171
LIABILITIES		
Current liabilities		
Outstanding cheques	**1,697**	
Bank loans and acceptances (Note 10)	**25,070**	11,539
Accounts payable and accrued liabilities	**18,106**	17,167
Income taxes payable	**45**	1,063
Instalments on long-term debt	**1,679**	4,408
	46,597	34,177
Long-term debt (Note 11)	**13,224**	12,760
Deferred income taxes	**4,132**	2,766
Deferred credits (Note 12)	**4,193**	1,806
	68,146	51,509
SHAREHOLDERS' EQUITY		
Capital stock (Note 13)	**37,846**	37,834
Retained earnings	**28,532**	19,828
	66,378	57,662
	134,524	109,171

The accompanying notes are an integral part of the consolidated financial statements.

On behalf of the Board,

Serge Racine
Director

Arthur P. Earle
Director

April 2, 1999 and April 3, 1998

(Amounts in the tables are in thousands of dollars)

1 - GOVERNING STATUTES AND NATURE OF OPERATIONS

The Company, incorporated under Part IA of the Companies Act (Québec), manufactures furniture.

2 - ACCOUNTING POLICIES

Principle of consolidation

The financial statements include the accounts of the Company and its wholly-owned subsidiaries. They also include the Company's share in the assets, liabilities, revenues and expenses of a jointly controlled enterprise. This share is accounted for using the proportionate consolidation method.

Inventory valuation

Finished goods and goods in process are valued at the lower of cost and net realizable value. Cost is determined by the average cost method.

Raw materials and supplies are valued at the lower of cost and replacement cost. Cost is determined by the first in, first out method.

Depreciation and amortization

Fixed assets are depreciated over their estimated useful lives according to the following methods, periods and annual rates:

	Methods	Periods and rates
Buildings	Straight-line	40 years
Machinery and equipment	Diminishing balance	10%
Rolling stock and software	Diminishing balance	30%
Office furniture	Diminishing balance	20%
Leasehold improvements	Straight-line	5 years
Forestry properties	Straight-line	25 years

Deferred charges are amortized according to the straight-line method over periods not exceeding 5 years.

Goodwill represents the excess of cost over the fair value of net assets acquired, and is amortized according to the straight-line method over a period of 10 years until 2003. The valuation and amortization of goodwill are revised regularly by management to ensure that no decrease in the value has occured, by comparing the accounting value with the non-actualized future cash flows generated by those assets.

Deferred credits represent government grants and investment tax credits resulting from the acquisition of fixed assets. The grants and tax credits are accounted for as deferred credits and amortized according to the same annual methods and rates as the assets to which they relate are depreciated.

Income taxes

The Company follows the deferred income tax allocation method in providing for income taxes. Under this method, timing differences between income for accounting purposes and income for tax purposes give rise to deferred income taxes.

The Company does not provide for income taxes on undistributed earnings of the foreign subsidiary as these earnings are being reinvested in such local operations.

Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of the contingent assets and liabilities and the reported amounts of revenues and expenses. Actual results could differ from these estimates.

Earnings per common share

The calculation of basic net earnings per common share is based on the weighted average number of outstanding shares during the years. The fully diluted net earnings per common share take into account all elements having a possible dilution effect.

(Amounts in the tables are in thousands of dollars)

2 - ACCOUNTING POLICIES (continued)

Foreign currency translation

Monetary assets and liabilities in foreign currency are translated at exchange rates in effect at the balance sheet dates, whereas other assets and liabilities are translated at exchange rates in effect at transaction dates. Revenue and expenses in foreign currency are translated at the monthly average rate in effect, with the exception of depreciation, which is translated at the historical rate. Gains and losses are included in the earnings for the years.

Assets and liabilities of the self-sustaining foreign subsidiary are translated into Canadian dollars at the exchange rate in effect at the balance sheet dates. Revenue and expenses are translated at the average rate in effect during the years. Gains and losses are included in the "Accumulated exchange adjustments" account of the shareholders' equity, if applicable.

Forward exchange contracts

The Company enters into foreign exchange contracts to manage its currency risk exposure. These financial instruments are presented at cost. Positions hedged by foreign exchange contracts are converted using the contract rate and the gains or losses are recognized to earnings during the years in which the revenues or expenses resulting from the corresponding hedged position are recorded.

3 - INFORMATION INCLUDED IN THE STATEMENT OF EARNINGS

	1999-04-02	1998-04-03
	$	$
Depreciation of fixed assets	**3,055**	2,184
Amortization of deferred charges	**1,131**	906
Amortization of goodwill	**54**	54
Amortization of deferred credits	**114**	107
Interest on short-term debt	**1,385**	900
Interest on long-term debt	**789**	1,114
Loss (gain) on foreign exchange	**466**	(830)
Revenue		
Discount on redemption of redeemable preferred shares		1,900

4 - INCOME TAXES

The difference between the Company's effective income tax rate and the combined Federal and Provincial income tax rate in Canada is explained as follows:

	1999-04-02	1998-04-03
	%	%
Income taxes at the combined Federal and Provincial income tax rate in Canada	**39.3**	39.1
Manufacturing and processing profits deduction	**(6.7)**	(6.7)
Permanent differences and other	**1.0**	(5.0)
Income taxes at the Company's effective income tax rate	**33.6**	27.4
	$	$
Income taxes are detailed as follows:		
Current	**3,035**	2,316
Deferred	**1,366**	1,275
	4,401	3,591

The tax benefit resulting from allowable capital losses is not recorded in the financial statements. These losses amount to $2,647,000 and may be carried-forward and applied against taxable capital gains over an indefinite period.

(Amounts in the tables are in thousands of dollars)

5 - BUSINESS ACQUISITIONS

On February 23, 1999, the Company acquired certain operating assets from a company operating a sawmill in North Anson, Maine, for an amount of $4,253,599 ($2,893,600 US) in cash.

On July 4, 1997, the Company acquired certain operating assets from a furniture manufacturing company in Sainte-Gertrude, Québec for an amount of $2,165,978. The Company financed this business acquisition through a $415,728 bearing note and a $1,750,250 term loan. This latter loan was subsequently paid with the proceeds from a share issue.

On May 29, 1997, the Company acquired a 50% ownership in Scierie Montauban Inc., which operates a hardwood sawmill, for an amount of $1,963,910. The Company financed this business acquisition through a $1,223,908 bearing note and $740,002 in cash.

These acquisitions were accounted for according to the purchase method. The results of operations since the dates of acquisition have been included in these consolidated financial statements. The above-mentioned net operating assets acquired are detailed as follows:

	1999-04-02	1998-04-03
	$	$
Current assets	**2,236**	1,733
Fixed assets	**2,018**	3,154
Current liabilities		(242)
Deferred income taxes		(31)
Long-term debt		(484)
Acquisition costs	**4,254**	4,130
Bearing notes issued		(1,640)
Cash acquired		(982)
Decrease in cash following these acquisitions	**4,254**	1,508

6 - ACCOUNTS RECEIVABLE

	1999-04-02	1998-04-03
	$	$
Trade accounts		
Canada	**5,636**	4,573
United States	**23,824**	18,554
	29,460	23,127
Sales taxes receivable	**1,731**	1,255
Other	**561**	493
	31,752	24,875

The United States trade accounts receivable are secured by a global multirisk insurance policy upon shipping.

7 - INVENTORIES

	1999-04-02	1998-04-03
	$	$
Finished goods	**20,987**	18,837
Goods in process	**11,409**	10,581
Raw materials	**11,653**	9,683
Supplies	**1,271**	1,145
	45,320	40,246

April 2, 1999 and April 3, 1998

(Amounts in the tables are in thousands of dollars)

8 - FIXED ASSETS

			1999-04-02
	Cost	**Accumulated depreciation**	**Net**
	$	**$**	**$**
Land	**1,847**		**1,847**
Buildings	**23,555**	**3,549**	**20,006**
Machinery and equipment	**35,908**	**10,161**	**25,747**
Rolling stock	**1,009**	**505**	**504**
Office furniture	**4,682**	**2,620**	**2,062**
Software	**3,749**	**805**	**2,944**
Leasehold improvements	**454**	**305**	**149**
Forestry properties	**631**	**32**	**599**
	71,835	**17,977**	**53,858**

			1998-04-03
	Cost	Accumulated depreciation	Net
	$	$	$
Land	1,076		1,076
Buildings	16,845	3,078	13,767
Machinery and equipment	28,655	8,293	20,362
Rolling stock	663	409	254
Office furniture	3,830	2,242	1,588
Software	2,498	709	1,789
Leasehold improvements	334	200	134
Forestry properties	631	6	625
	54,532	14,937	39,595

9 - OTHER ASSETS

	1999-04-02	1998-04-03
	$	$
Deferred charges, at amortized cost		
New product development costs	**1,124**	1,003
Start-up costs	**1,017**	624
Promotional material	**508**	534
Financing charge	**148**	
	2,797	2,161
Goodwill, at amortized cost	**215**	269
	3,012	2,430

10 - BANK LOANS AND ACCEPTANCES

The Company has total authorized operating credits of $32,500,000 ($22,500,000 as at April 3, 1998), which can be used as bank loans or acceptances. These amounts can be drawn out in Canadian or American dollars. As at April 2, 1999, the bank loans bear interest at prime rate or US prime rate (prime rate for the first $13,250,000 and prime rate plus 0.25% for the balance as at April 3, 1998), and this rate is reviewed on a quarterly basis. The bank acceptances are at the market rate. The operating credits are established for a three-year term, renewable on September 30 of each year for an additional year and are subject to the restrictions mentioned in Note 11(*).

(Amounts in the tables are in thousands of dollars)

11 - LONG-TERM DEBT

	1999-04-02	1998-04-03
	$	$
Loan, prime rate plus 0.5%, payable in quarterly capital instalments of $300,000, maturing no later than 2003 (*)	**12,200**	
Loans, secured by immovable assets and machinery, prime rate plus 0.5% to 2%, payable in varying monthly instalments until 2004	**1,049**	1,276
Loan, lender's prime rate, payable in monthly capital instalments of $13,649, maturing in 2001	**396**	560
Non-interest bearing loans, payable in annual instalments, maturing at various dates until 2007	**1,258**	2,199
Loans, 8.55% and prime rate plus 1.25% until September 1998 and prime rate plus 1.25% thereafter, payable in monthly capital instalments of $16,892 until September 1998 and $175,083 thereafter		9,775
Loans, interest rate equal to the lender's interest cost plus 1.75%, payable in monthly capital instalments of $33,250		1,908
Loan, prime rate plus 1%, payable no later than 1998		1,224
Loans, lender's prime rate, payable in monthly capital instalments of $45,104		226
	14,903	17,168
Instalments due within one year	**1,679**	4,408
	13,224	12,760

(*) This loan and the short-term bank loans and acceptances are secured by a first rank mortgage on the universality of all present and future movable and immovable, tangible and intangible assets, for an amount of $70,000,000. The Company is subject to certain restrictions under the credit agreement. The major restrictions require that the Company maintain a working capital ratio of at least 1.3, a long-term debt to shareholders' equity ratio no greater than 1.0, a debt on earnings before income taxes, interest and amortization ratio no greater than 4.0 and an interest coverage ratio of at least 3.0. The Company was in compliance with these restrictions as at April 2, 1999.

The instalments on long-term debt for the next five years are $1,678,831 in 2000, $1,803,012 in 2001, $1,579,099 in 2002, $1,545,444 in 2003 and $7,730,405 in 2004.

12 - GOVERNMENT ASSISTANCE

In 1999, the Company obtained from the Department of Economic Development and Tourism of New Brunswick, a $2,000,000 contribution relating to investments in fixed assets.

This government contribution was reported and presented in the balance sheet as deferred credits. This contribution could be redeemable in part if the Company does not maintain a certain number of jobs during a twelve-month period ending on December 31, 2001.

13 - CAPITAL STOCK

Authorized

Unlimited number of common shares, without par value, voting and participating

Unlimited number of preferred shares of first and second rank, without par value, which can be issued in one or more series, for which the directors will determine their number, designation, rights, privileges, conditions and restrictions

Preferred shares of second rank, series 1, annual and non-cumulative dividend of $0.06 per share, non-voting, non-participating, redeemable at the Company's option at the paid-up capital amount

(Amounts in the tables are in thousands of dollars)

13 - CAPITAL STOCK (continued)

	1999-04-02		1998-04-03	
	Number of shares	**Amount**	Number of shares	Amount
		$		$
Issued and fully paid				
Common shares				
Balance, beginning of year	**13,282,674**	**37,385**	11,232,674	11,180
Issue of shares for cash			1,600,000	25,600
Stock options exercised for cash	**2,000**	**12**	450,000	605
Balance, end of year	**13,284,674**	**37,397**	13,282,674	37,385
Preferred shares of second rank, series 1				
Balance, beginning and end of year	**700,000**	**449**	700,000	449
		37,846		37,834

The Company has reserved 500,000 common shares as a stock option plan for directors and officers. As at April 2, 1999, a total of 315,500 options (217,500 options as at April 3, 1998) were granted of which 191,500 can be exercised at prices varying from $6.25 to $17.00 per share until 2008.

14 - COMMITMENTS

The Company has entered into long-term lease agreements, expiring at the latest in 2001, which call for lease payments of $491,536 for the rental of premises. Minimum lease payments for the next years are $402,645 in 2000 and $88,891 in 2001.

15 - FAIR VALUE OF THE FINANCIAL INSTRUMENTS

Primary financial instruments

Cash, accounts receivable, outstanding cheques, bank loans and acceptances, accounts payable and accrued liabilities are short-term financial instruments whose fair value approximates their carrying amount given that they will mature shortly.

The estimated fair value of the Company's long-term debt is determined based on analyses of the discounted value of cash flows, using interest rates in effect for the Company's similar borrowing agreements. The carrying amount is $14,902,708 ($17,167,281 as at April 3, 1998) and there is no material difference with the fair value.

Derivative financial instruments

As at April 2, 1999, the Company is committed, by virtue of forward exchange contracts, to sell $95,000,000 ($74,000,000 as at April 3, 1998) US dollars for Canadian dollars at an average rate of 1.4764 (1.392 on April 3, 1998). The fair value of the derivative financial instruments is determined based on prices obtained from the Company's brokers for identical or similar financial instruments. The fair value of the forward exchange contracts is positive by $1,738,900 as at April 2, 1999 (negative by $1,425,000 as at April 3, 1998).

(Amounts in the tables are in thousands of dollars)

16 - SHARE IN A JOINTLY CONTROLLED ENTERPRISE

The principal components of the share in the jointly controlled enterprise included in the consolidated financial statements consist of the following:

	1999-04-02	1998-04-03
	$	$
Consolidated balance sheet		
Current assets	**762**	1,029
Long-term assets	**1,949**	2,043
Current liabilities	**481**	474
Long-term liabilities	**666**	779
Consolidated changes in cash resources		
Funds provided (used) in operations	**76**	(242)
Funds provided (used) by financing	**(37)**	858
Funds used for investment	**(30)**	(803)

Since the jointly controlled entreprise's major role is that of supplying the Company, income earned from third parties as well as related expenses are not material.

17 - GEOGRAPHIC BREAKDOWN OF REVENUE

The Company's revenue can be broken down geographically as follows:

	1999-04-02	1998-04-03
	$	$
Canada	**27,889**	27,551
United States	**100,245**	81,887
	128,134	109,438

18 - UNCERTAINTY DUE TO THE YEAR 2000 ISSUE

The Year 2000 Issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the year 2000 as 1900 or some other date, resulting in errors when information using year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the Year 2000 Issue may be experienced before, on, or after January 1, 2000, and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure which could affect an entity's ability to conduct normal business operations.

It is not possible to be certain that all aspects of the Year 2000 Issue affecting the Company, including those related to the efforts of customers, suppliers or other third parties, will be fully resolved.

In order to mitigate these risks, the Company has assessed the effects of the Year 2000 Issue and developed and implemented an action plan for its information systems and its business relations with its customers and suppliers.

BOARD OF DIRECTORS

Serge Racine [1] [3]
Chairman of the Board, President and Chief Executive Officer
Shermag Inc.

Charles Chamard [2] [3]
Corporate Director

Arthur P. Earle [1]
Consultant

Jean-Côme Gaudet [2]
Management Consultant

Jacques A. Nadeau [2] [3]
Senior Vice-president
MédiSolution

Claude Pichette [1]
Counselor, Conflicts and Litigation
Huis Clos Ltée

John D. Thompson [1]
Deputy Chairman
Montréal Trust

Jeanne Wojas [3]
Lawyer and Corporate Director

(1) Member of the Executive Committee
(2) Member of the Audit Committee
(3) Member of the Human Resources Committee

MANAGEMENT

Serge Racine
Chairman of the Board, President and Chief Executive Officer
Shermag Inc.

Josée Bélanger
Corporate Secretary

Guy Cardinal
Vice-president, Production

Josée Girard
Comptroller

Claude Sauvé
Vice-president, Administration

Aurèle Turcotte
Executive Vice-president and Chief Operating Officer

CORPORATE INFORMATION

Transfer Agent
General Trust of Canada
1100, rue University
Montréal (Québec)
H3B 9Z9

Auditors
Raymond Chabot Grant Thornton
Sherbrooke (Québec)

Bank
National Bank of Canada

Stock Registration
Shermag Inc.'s shares are listed on the Montréal Exchange and the Toronto Stock Exchange under symbol SMG.

Annual Information Form and General Information
To obtain a copy of the Annual Information Form submitted to the Québec Securities Commission and the Ontario Securities Commission or for any additional information regarding the Company, please send a written request to the Company's Secretary or to the Transfer Agent.

Annual General Meeting of Shareholders
Thursday, August 26, 1999 at 16:00
Club Saint-Denis
257, rue Sherbrooke Est
Montréal (Québec)

DIVISIONS

BÉDARD

Émile Hudon, President

726, rue Principale
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chanderic
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Ronald Jeghers, President

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Scotstown

Denis Charest, President

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Bishopton (Québec)
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510, rue Saint-François
Disraeli (Québec)
G0N 1E0

10, rue Albert
Scotstown (Québec)
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Placages Lennox

André Beauregard, Manager

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General Manager

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Shermag Corp. DBA WOODTEK

Daniel Lefebvre
General Manager

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SOFAS INTERNATIONAL

Normand Couture, President

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JOINTLY CONTROLLED ENTERPRISE

Scierie Montauban Inc.

Daniel Lefebvre
General Manager

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Shermag inc.

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